TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Investment Insight Series - Hedge Funds	ITEM NUMBER: 9
	ATTACHMENTS: 2
ACTION: ____	DATE OF MEETING: December 4, 2002
INFORMATION: X	PRESENTER: Christopher Ailman

Executive Summary

This is the first of three "investment insight" programs for Fiscal year 2002 - 2003. This presentation will delve into the complex and mysterious world of hedge funds.

Background:

These investment funds have continued to be the "hot topic" at most of the pension industry investment conferences for the past two years. Additionally, hedge funds are often quoted by the financial press as the cause of any sharp reversal of direction in the stock market. They have even been blamed for the currency crisis in Malaysia and Russia. It has even been suggested they had something to do with the collapse of two prominent Northern California sports teams in the critical game 6 versus their Southern California opponents. Obviously, hedge funds cannot be responsible for all these events. However, these often maligned groups of investment funds are clearly a major player in today's global financial markets.

Hedge funds are not a separate asset class; in fact they are not homogenous at all. There are 18 different types of funds that can invest in any financial market and security in the world. Industry researches disagree on the number of Funds in the world, the London School of Economics gauges it at 2500 funds worldwide, and while U.S. researches place it at over 5000 hedge funds. It is estimated that these funds manage between $400 to $600 billion in assets. Since two people and a computer in a garage can establish a fund it's no wonder it's difficult to gauge the market.

It is also difficult to track the investment area because it is largely unregulated. In addition, there's very little transparency of holdings and/or investment process. Several managers, called multi-process funds, can even change strategies to suit their view of the market. Since it is so easy to establish oneself as hedge fund, it becomes equally difficult to track the performance of the industry. The MCSI hedge fund index standards allow fund to submit their data after just six-month track record and only $75 million under management. Some small funds that encounter a period of poor performance have closed up the shop only to reemerge as a new fund under a new name. As a result, past performance of the industry is skewed by a large survivorship bias.

In staff's view MSCI has done the most extensive job of mapping the hedge fund universe. Overall hedge funds fit into five general basic strategies with up to four investment styles in each area. There will be quiz at the meeting mapping each style to each strategy.

Relative Value	**Security Selection**	**Directional Trading**	**Specialist Credit**	**Multi-process Group**
Arbitrage (Convertible)	Long bias	Discretionary trading	Distressed securities	Event Driven
Statistical arbitrage	No bias- Market neutral	Tactical allocation	Long-short credit	Multi- process
Merger arbitrage	Short bias	Systematic trading	Private placements	
Multi-process	Variable bias	Multi-process	Multi-process	

Source: MSCI Hedge Fund Indices

Each of these investment styles can used over the following asset classes and geographic regions:

Asset class	**Geography** Area, regional and country specific		
Commodities	U.S.A.	North America	Global diversified
Convertibles	Europe	Pacific Basin - East Asia	Europe
Equity	Japan	Emerging markets diversified	Asia
Fixed Income	Pacific ex- Japan	Latin America	Global - Asia

Source: MSCI Hedge Fund Indices

Hedge fund investing is about manager skill and not about the underlying asset exposure. Since many of the strategies allow the fund managers to both buy and sell a particular asset type, the net exposure to that asset is zero. However, the investor has actually doubled the exposure to the specific security movement. For example in a long/short or market neutral strategy, the manager might buy a particular electric utility stock and short another electric utility stock. The net exposure to stocks is zero, yet the investor has exposure to the movement of each stock. This strategy can be applied to almost any security in the world.

If the goal of selecting active managers is to find "alpha," then hedge funds offer two alpha, because the manager must be able to make good decisions long and short. The theory goes that if the manager can pick stocks that will go up, they should be able to pick stocks that go down. Sounds simple, yet skill at consistently beating any market is very hard to find.

In the case of global macro funds, the manager can be "long" one currency and "short" the bonds of a different country to lock-in the "expected" movement from a global political event. In most of the hedge fund strategies, the net exposure to any security or market is limited. As a result the returns generated can be "transported" to any asset class by purchasing futures. Keep in mind, it is very difficult to track the industry returns for hedge funds. There are no established benchmarks to evaluate most of the strategies because many funds are not restricted to a particular asset class or strategy.

Hedge funds carry the moniker of risky investments, in part due to their high use of leverage. By borrowing on the initial investments, or using derivative securities, managers attempt to amplify their ability to outguess the markets. However, leverage cuts both ways as in the case of Long-Term Capital Management.

Part of the lure of hedge funds is that they are most often employed by the University Endowment funds. These investors have a typical aggressive asset allocation that is 80% equity and 20% fixed. Within their equity allocations, they tend to prefer higher risk strategies such as private equity and hedge funds. A study completed in 2000, revealed that the average Endowment had an 8% allocation to hedge funds compared to an average private equity allocation of 26%. Listed below are some of the well known Endowments and then CalPERS which serves as a comparison of a similar size fund to CalSTRS.

FUND	**SIZE (Millions)**	**Percent allocated to Hedge Funds**	**$ Amount invested**
Yale	$10,500	22.50%	$2,363
Harvard	$14,300	9.70%	$1,387
Stanford University	$6,960	12.00%	$835
Cornell	$3,960	19.20%	$760
U of North Carolina	$1,000	24.40%	$244
CalPERS	$135,000	0.30%	$411

To assist the Investment Committee in this overview of the hedge fund world, staff has included a PowerPoint report by Pension Consulting Alliance labeled **Attachment 1**. **Attachment 2** is a memo from ISI Group that provides a third party view of the industry. In addition, staff has assembled a panel of industry thought leaders to share their experience and information about the wide and wild world known as hedge funds.

The panelists are:

Monica Butler, Director of Consulting, Frank Russell Investment Group
Robert J. Kulperger, Jr., Vice President, Tremont Advisers

Monica Butler, Director of Consulting
Russell Investment Group

Monica Butler is the director of Russell's U.S. consulting group. Russell consulting provides advice to large institutional funds on all aspects of their investment programs, including investment policy and asset allocation, asset class strategy, manager selection, and performance analysis. Monica was named director in January 1996. The U.S. consulting practice advises U.S.-based organizations that currently represent more than $400 billion in assets. In addition to managing the group, Monica acts as a senior consultant for several consulting client relationships. Monica received a Bachelor of Science from Cornell University in 1976 and her M.B.A. in Finance from New York University in 1980.

Monica joined Frank Russell Company in 1982 as an equity research analyst responsible for evaluating money managers and developing U.S. equity strategy for clients. She eventually headed the value style subgroup. Prior to Russell, from 1980 to 1982, Monica was a securities analyst at Sanford C. Bernstein & Co., Inc., where her investment research responsibilities concentrated in the food and food processing industries.

Robert J. Kulperger, Jr.
Vice President, Director of U.S. Institutional Sales and Education

Robert Kulperger is responsible for providing information and sales support to existing institutional clients and potential investors. His focus is on pension fund sponsors, consultants, endowments and foundations and other major institutions. Mr. Kulperger previously served as the Director of Research and as a member of the Investment Committee at Tremont.

Prior to joining Tremont, Mr. Kulperger was a Vice President and the Co-Head of the Alternative Investments Group at Nomura Securities International, Inc. At Nomura, he co-headed the group responsible for creating, structuring and monitoring custom-made fund of hedge funds and other alternative products for Japanese institutional investors. Prior to Nomura, Mr. Kulperger was an attorney in the Corporate and Securities practice group at Arnold & Porter, a Washington, D.C. law firm.

Mr. Kulperger has a Bachelor of Arts degree in International Relations from Brown University, and a Master of Arts equivalent in European Administration from the College of Europe (Fulbright Scholarship), and a Juris Doctorate from Stanford Law School.

A Review of Hedge Fund Investing

By Pension Consulting Alliance, Inc.

August 2002

Discussion of Hedge Funds

- Review Issues
- Hedge Fund Characteristics and Attributes
- Tenets of a Successful Hedge Fund Program
- Conclusions

Discussion of Hedge Funds
Introduction

- Original concept:

In 1949, Alfred Jones established the first hedge fund in the US. The defining characteristic of this hedge fund was that it hedged against the likelihood of a declining market. Mr. Jones's model was based on the premise that performance depends more on stock selection than market direction. Jones utilized two speculative tools to implement his strategy: short selling and leverage. Mr. Jones used leverage to obtain profits, but employed short selling through baskets of stocks to control risk.

Source: Tremont Partners

- Today's definition:

A "hedge fund" refers broadly to any private pool of capital whose investment manager is compensated primarily on the fund's performance. Hedge funds seek superior returns relative to risk by utilizing a broad spectrum of investment styles, hedging strategies and financial instruments that have low or no market risk. The manager generally has a significant commitment of personal net worth invested in the fund.

Source: Hennessee Group

- In 1990: approximately $35 billion in capital and an estimated 300 funds

- Today: over $500 billion in capital and up to 5,000 funds

Discussion of Hedge Funds
Hedge Fund Issues

- Hedge funds are not an asset class
  - a type or style of asset management
    - normally skill based
  - not homogenous (not many common factors)

- Hedge funds are commonly considered alternative investments because they:
  - are privately structured and limited to “sophisticated” investors
  - can contain significant financial leverage and contain other risk factors
    - financial leverage (use of margin accounts and short-term loans)
    - instrument leverage (use of derivatives that magnify returns)
  - span a broad array of high risk strategies, producing highly volatile returns
  - exhibit return behaviors that can be independent from other asset classes

Discussion of Hedge Funds

Hedge Fund Issues

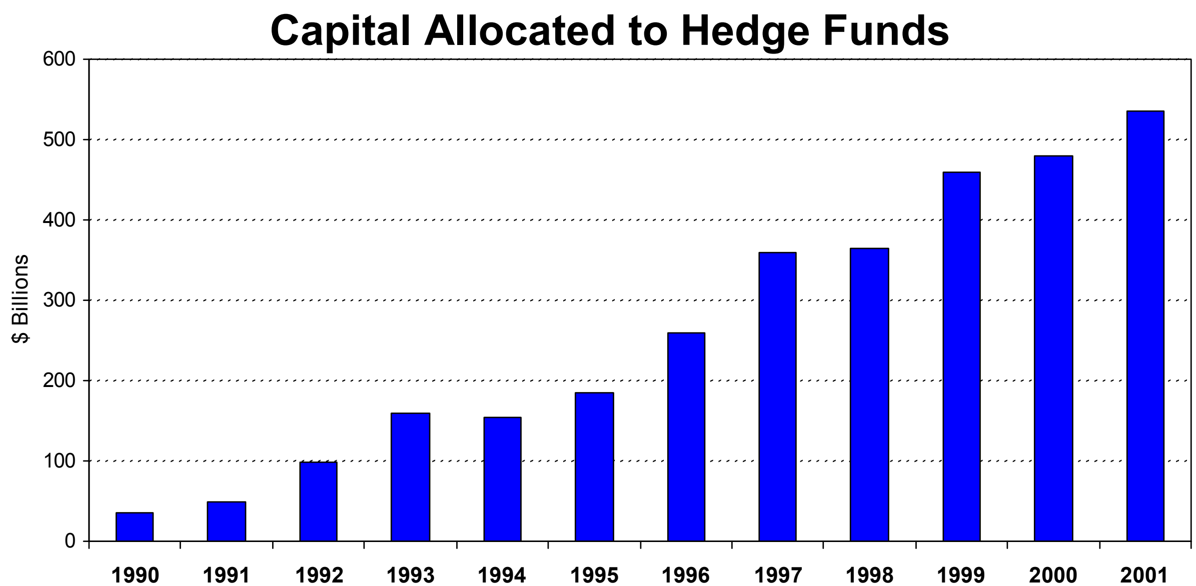
- Can be considered a sub-set of equity or debt
  - when a strategy is linked to an asset class
    - long equity only, long fixed income only or overlay of an asset class

- Hedge funds also used as tool to create “portable alpha”
  - not a widely accepted strategy
  - requires high level of comfort with alternative risk measures
  - implementation and monitoring will be more difficult (disclosure hurdles)
  - added value may only be a “risk transfer” in disguise

Discussion of Hedge Funds
Hedge Fund Issues

- Arguments of hedge fund investing
  - Pros:
    - low correlation to other major asset classes
    - potential for high returns
    - claim ability to add value throughout market cycles
  - Cons:
    - high dispersion of returns
    - lack of transparency
    - concerns of fraud
    - highly unregulated

Discussion of Hedge Funds
Trends



- Hedge funds have exhibited significant growth
  - estimates vary significantly
  - from approximately 300 funds in 1990 to more than 3,000 today
    - some estimate up to 5,000
  - estimated to be over $500 billion in capital, before leverage
  - pace of commitments to hedge funds continued to accelerate thru 2001

- Concern: too many assets flowing into management style/approach

Discussion of Hedge Funds

Characteristics and Attributes

- Lack of disclosure
  - regulators require that hedge funds do not promote their services
    - result: an unclear picture of industry performance
  - hedge funds disclose only limited amounts of investment data
    - fund's current investors have incomplete knowledge fund investments
  - summary: hedge fund managers compelled to withhold information
- There is a huge amount of survivorship bias in industry
  - it is estimated that 20% of hedge funds fail each year
  - survivorship bias skews industry performance statistics

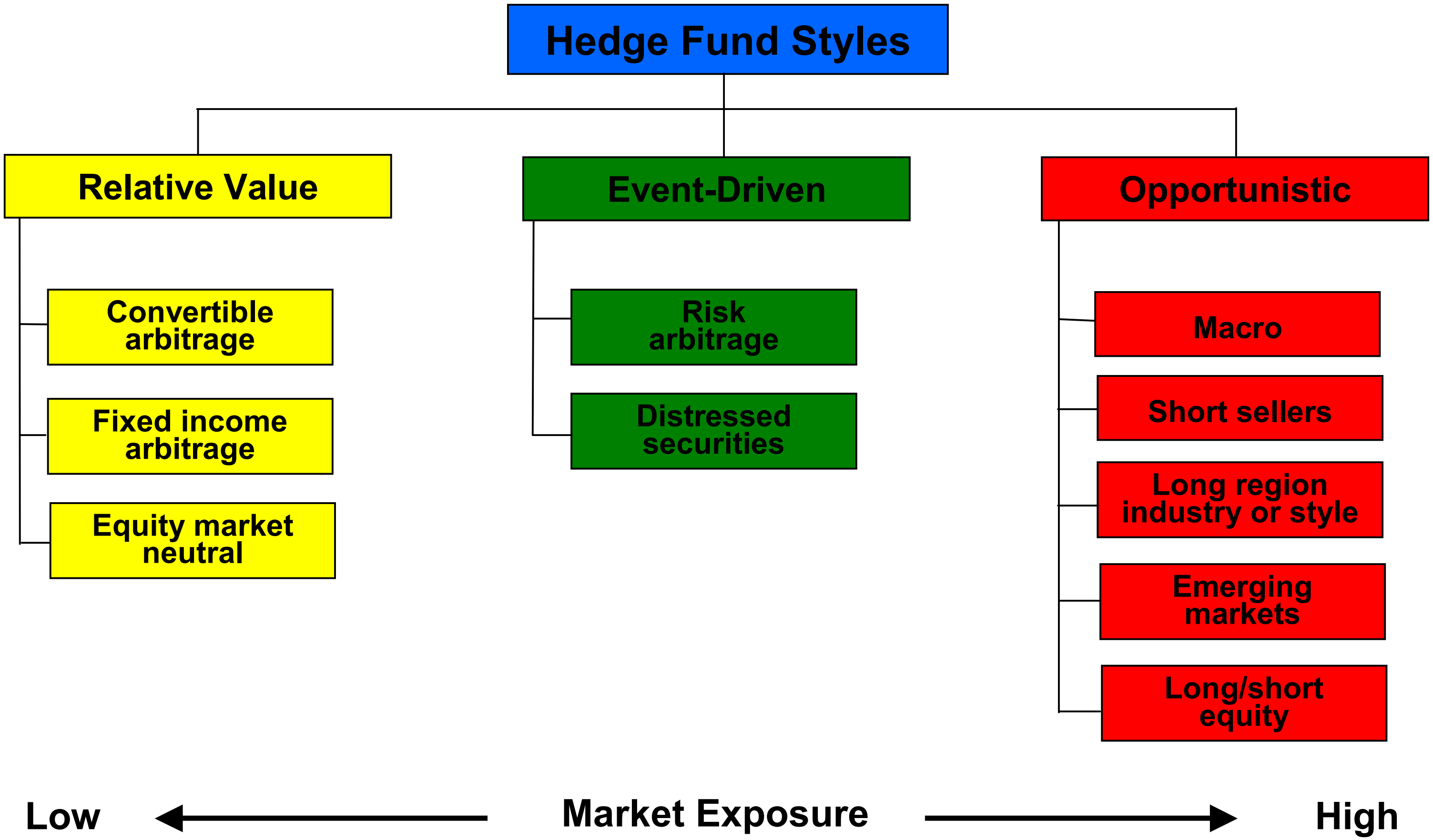
Discussion of Hedge Funds
Characteristics and Attributes

- Higher costs
  - commonly 1% management fee with a 20% performance fee
- Lower liquidity, commonly:
  - quarterly redemptions with restrictions
  - one-year "lock-up"
  - however, more liquid than other alternative investments (i.e. private equity, real estate, etc.)
- Range of performance targets
  - absolute return targets (i.e., 10%-20% per year)
  - relative return targets (i.e., T-Bills + 5% over a market cycle)
- Spectrum of investment strategies and approaches

Discussion of Hedge Funds

Characteristics and Attributes

- Manager styles can be organized by market exposure



Source: UBS Warburg, “In Search of Alpha”

Discussion of Hedge Funds

Characteristics and Attributes

Strategies	Definition
Relative Value	
Convertible Arbitrage	Invests in the convertible securities of a company. A typical investment is to be long the convertible bond and short the common stock of the same company. Positions are designed to generate profits from the fixed income security as well as the short sale of the stock, while protecting the principal from market moves.
Fixed Income Arbitrage	Fixed income arbitrage managers seek to exploit pricing anomalies within and across global fixed income markets and their derivatives, using leverage to enhance returns. In most cases, fixed income arbitrageurs take offsetting long and short positions in similar fixed income securities that are mathematically, fundamentally or historically interrelated. The relationship can be temporarily distorted by market events, investor preferences, exogenous shocks to supply or demand, or structural features of the fixed income market.
Equity Market Neutral	Equity market-neutral is designed to produce consistent returns with very low volatility and correlation in a variety of market environments. The investment strategy is designed to exploit equity market inefficiencies and usually involves being simultaneously long and short matched equity portfolios of the same size within a country. Market neutral portfolios are designed to be either beta or currency-neutral or both. Equity market-neutral is best defined as either statistical arbitrage or equity long/short with zero exposure to the market.
Event Driven	
Risk Arbitrage	Risk arbitrage (also known as merger arbitrage) specialists invest simultaneously in long and short positions in both companies involved in a merger or acquisition. In stock swap mergers, risk arbitrageurs are typically long the stock of the company being acquired and short the stock of the acquiring company. In the case of a cash tender offer, the risk arbitrageur is seeking to capture the difference between the tender price and the price at which the target company's stock is trading.
Distressed Securities	Distressed securities funds invest in the debt or equity of companies experiencing financial or operational difficulties or trade claims of companies that are in financial distress, typically in bankruptcy. These securities generally trade at substantial discounts to par value. Hedge fund managers can invest in a range of instruments from secured debt to common stock. The strategy exploits the fact that many investors are unable to hold below investment grade securities.
Opportunistic	
Macro	Macro hedge funds pursue a base strategy such as equity long/short or futures trend following to which large scale and highly leveraged directional bets in other markets are added a few times each year. They move from opportunity to opportunity, from trend to trend, from strategy to strategy.
Short Sellers	The short selling discipline has an equity as well as fixed income component. Short sellers seek to profit from a decline in the value of stocks. In addition, the short seller earns interest on the cash proceeds from the short sale of stock.
Long Region, Industry, or Style	Traditional equity fund structured like a hedge fund; ie, uses leverage and permits managers to collect an incentive fee. Focus of the fund could be a specific geographic region (i.e., Japan) , industry (i.e., technology) or style (i.e., growth)
Emerging Markets	Emerging market hedge funds focus on equity or fixed income investing in emerging markets as opposed to developed markets. This style is usually more volatile not only because emerging markets are more volatile than developed markets, but because most emerging markets allow for only limited short selling and do not offer a viable futures contract to control risk. The lack of opportunities to control risk suggests that hedge funds in emerging markets have a strong long bias.
Long/Short Equity	Long/short strategies combine both long as well as short equity positions. The short positions have three purposes, which can vary over time or by manager. First, the short positions are intended to generate alpha. This is one of the main differences when compared with traditional long-only managers. Stock selection skill can result in doubling the alpha. A long/short equity manager can add value by buying winners as well as selling losers. Second, the short positions can serve the purpose of hedging market risk. Third, the manager earns interest on the short as he collects the short rebate.

Discussion of Hedge Funds
Market Neutral

Market Neutral: This investment strategy is designed to exploit equity market inefficiencies and usually involves being simultaneously long and short matched equity portfolios of the same size within a country. Market neutral portfolios are designed to be either beta or currency neutral, or both. Well designed portfolios typically control for industry, sector, market capitalization and other exposures. Leverage is often applied to enhance returns.

- Attempt to create zero net exposures (neutrality)
  - beta neutral
  - dollar neutral
  - sector neutral
  - investment style neutral
  - capitalization neutral

- Claims “purest” form of alpha generation in the equity arena
  - portable alpha

Discussion of Hedge Funds
Long/Short Equity

Long/Short Equity: This directional strategy involves equity-oriented investing on both the long and short sides of the market. The objective is not to be market neutral. Managers have the ability to shift from value to growth, from small to medium to large capitalization stocks, from a net long position to a net short position. Managers may use futures and options to hedge. The focus may be regional, such as long/short US or European equity, or sector specific, such as long and short technology or healthcare stocks. Long/short funds tend to build and hold portfolios that are substantially more concentrated than those of traditional stock funds.

- Greater market exposure
  - magnitude and direction dependent upon manager strategy
  - higher correlation with equity market

- Some downside protection in declining equity markets
  - due to exposure to short positions

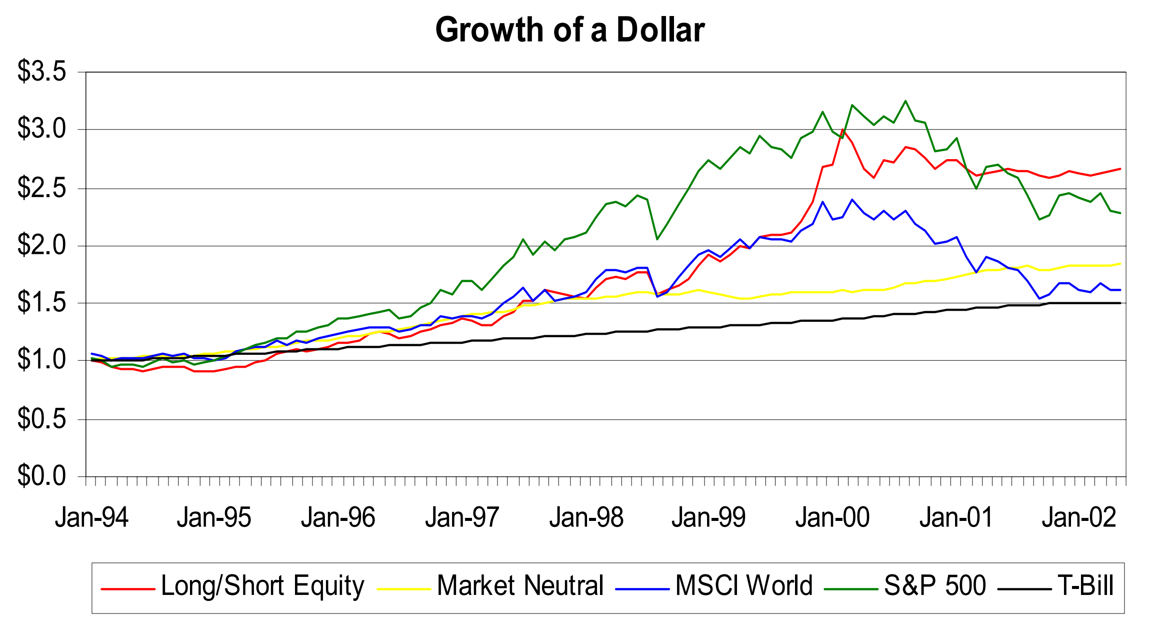
Discussion of Hedge Funds
Market Neutral vs. Long/Short Equity

- Market Neutral
  - offsetting exposures attempting to capture small pricing discrepancies
  - attempts to capture/exploit reversion to the mean tendencies
  - lower expected returns and lower expected volatility than other strategies
  - capital preservation is typically a priority

- Long/Short Equity
  - does not necessarily depend on convergence or reversion to the mean tendencies
  - utilizes more opportunistic strategies
  - less homogeneous group
  - higher expected returns with higher expected volatility

Discussion of Hedge Funds

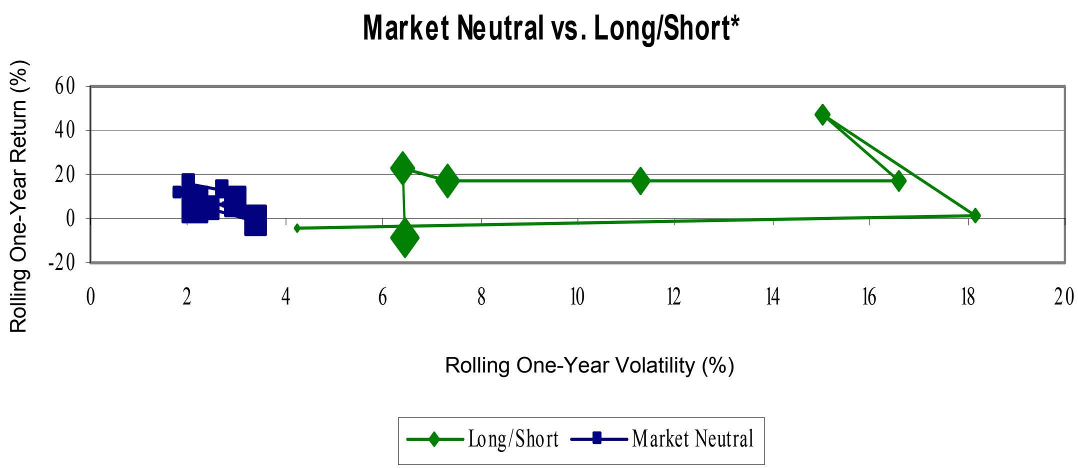
Market Neutral vs. Long/Short Equity



- Market Neutral has exhibited consistent added value with low volatility
  - total returns significantly less than equities, requires overlay implementation
  - key issue: is market neutral pattern more consistent than long-only manager alphas?
- Long/Short has exhibited strongest results with greater volatility
  - significantly underperformed until late 1999
    - captured bubble and preserved principal over last two years
  - key issue: long/short correlated to equities, will it outperform in the future?

Discussion of Hedge Funds

Market Neutral vs. Long/Short Equity



* Larger marker indicates more recent time period.

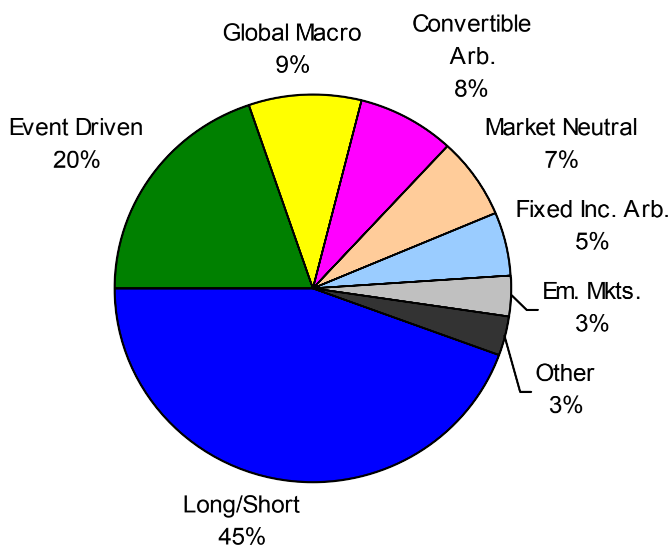
- Market Neutral has exhibited substantially less volatility
  - leading to higher risk-adjusted returns vs. long/short

- Long/short has potential to produce equity like risks

Discussion of Hedge Funds

Characteristics and Attributes

- Breakout of Hedge Fund Industry by Major Strategy Type



By Assets
(as of 12/31/01)

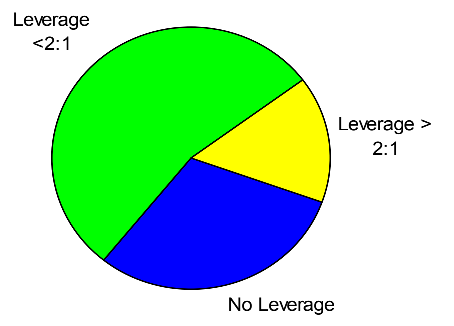
- Market dominated by Long/Short, Event Driven and Global Macro

Source: TASS Asset Flows – January 1994-December 2001

Discussion of Hedge Funds
Characteristics and Attributes

- Breakout of hedge fund industry by use of leverage

Leverage as a Multiple of Equity Capital



- nearly 70% of hedge funds use leverage
- of those hedge funds using leverage, most apply less than 2:1 multiple
  - 2:1 still significant
  - ERISA mandates a *maximum* 2:1 ratio
- issue: limiting leverage lowers potential for “high octane” return pattern

Source: IMF, Mar/Hedge

Discussion of Hedge Funds

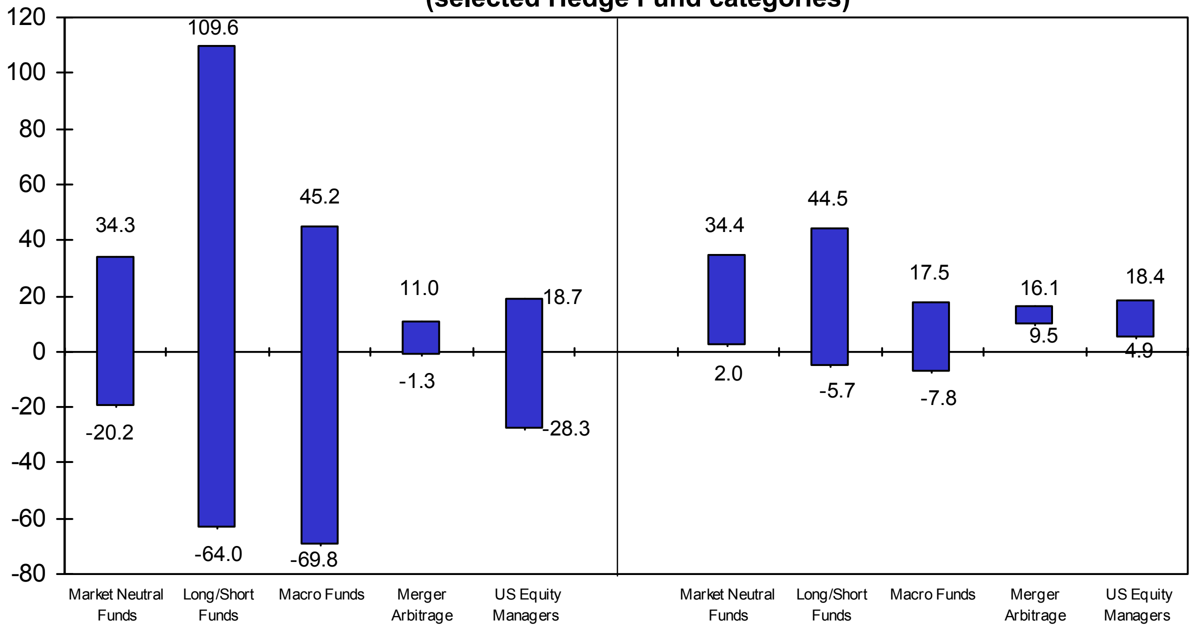
Characteristics and Attributes

- Dispersion of Returns
  - there are different notions of return dispersion (volatility):
    - the actual dispersion of manager returns
    - the volatility of a strategy category's returns
  - understanding these differences is critical to program structure

Discussion of Hedge Funds
Characteristics and Attributes

- Dispersion of Returns - Actual Dispersion of Managers

Dispersion of Manager Returns Comparison - Periods ending 12/31/01
(selected Hedge Fund categories)



Universe Participants

85	114	24	59	1,466	24	37	8	24	552

One Year **Five Years**

- Dispersion of hedge manager returns often *greater* than equity managers
- Market neutral manager returns widely dispersed
  - notion of "consistent alpha" not evident
- Merger arbitrage managers most consistent, long/short managers least consistent
- Significant survivorship bias evident

Source: Altvest, TUCS, PCA

Discussion of Hedge Funds
Characteristics and Attributes

➢ Dispersion of Returns - Comparison of Dispersion Measures

Dispersion of Manager Returns Comparison - Periods ending 12/31/01

(selected Hedge Fund categories)

	Market Neutral	Macro	Long/ Short	Merger Arbitrage
Actual Max-Min Range (see prior slide)	32.4	25.3	173.6	6.6
Standard Deviation of Sector Composites*	4.2	18.6	7.7	3.8

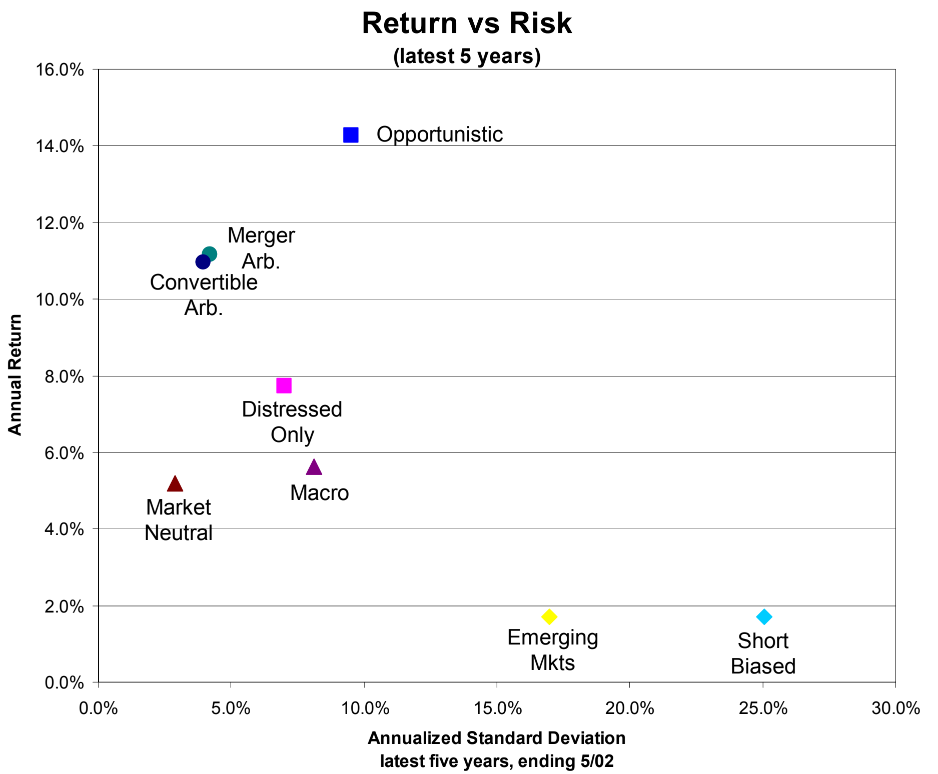
*Calculated based on annualized standard deviation of time series of composite performance. Sector composites constructed by equal-weighting managers in composites over monthly periods and then linking returns over required horizon. The lower the cross correlations among managers, the more diversified (less volatile) the sector composite will be versus the range of returns from individual managers.

Source: Altvest, PCA

- sector composite risk lower than actual range experienced by managers
  - reason: lack of perfect correlation among a sector's managers
- two important implications:
  - the selling of hedge concepts often based on sector, not manager, results
  - <u>manager diversification is critical</u> to risk management within certain sectors
- diversification especially critical within market neutral and long/short sectors
  - managers more highly correlated in other selected sectors

Discussion of Hedge Funds

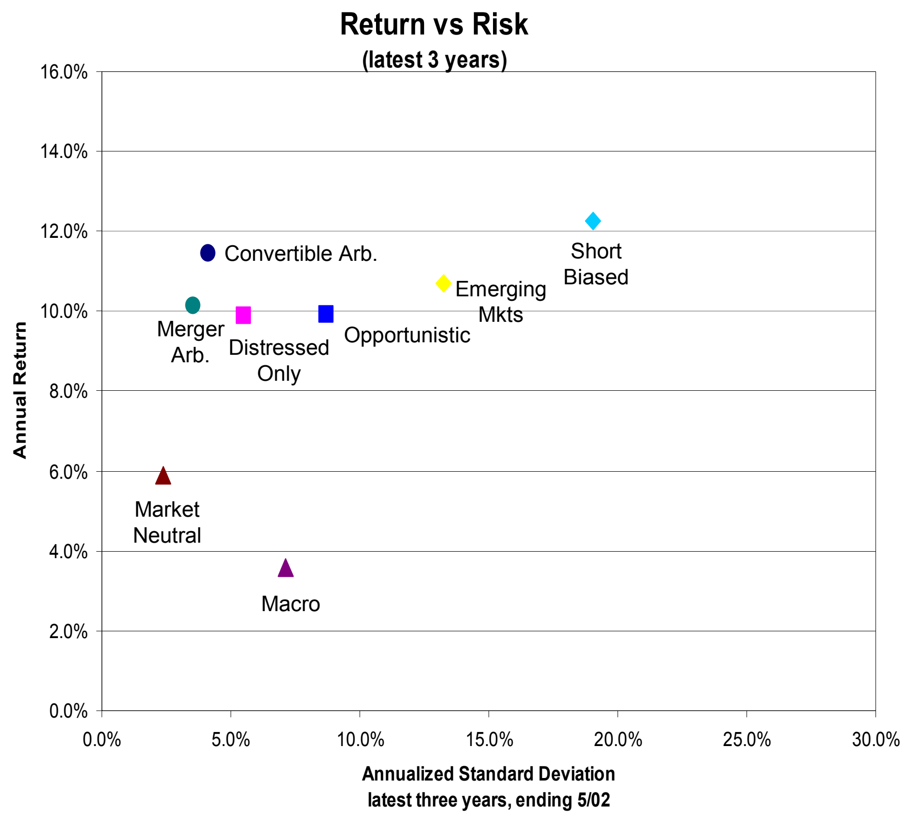
Characteristics and Attributes



- Strategies have a spectrum of risk and return characteristics
  - difficult period for emerging markets and short biased strategies

Source: Altvest, CSFB/Tremont, Hennessee

Discussion of Hedge Funds
Characteristics and Attributes



- Dramatic improvement for emerging markets and short biased strategies
  - reflective of greater market exposures

Source: Altvest, CSFB/Tremont, Hennessee

Discussion of Hedge Funds

Summary of *Characteristics and Attributes*

- The hedge fund universe is extensive
  - large number of funds
  - broad spectrum of strategies

- There are several risks unique to hedge funds:
  - disclosure risk
  - partnership mortality risk (average life of partnership - 3 yrs.)
  - financial leverage risk (mitigated to some degree by ERISA)
  - return dispersion risk

- Other risks:
  - event risk
    - correlations tend to increase during global shocks
  - manager selection risk
  - complexity risks (of process, of transactions, of securities)
  - personnel risks (hedge funds are usually run by smaller firms)
  - asset growth (too large an asset base threatens nimbleness)
  - liquidity risk
  - fraud risk

HEDGE FUND NATION

Market Implications of the Rapid Growth in the Number of Hedge Funds

I can tell by the nervous laughter and the eye-rolls from our institutional salesmen that talking about hedge funds has become the third rail of sell-side investment strategy. Few people are agnostic about these investment pools. Long-only managers often see them as a blight upon the landscape of long-term investing, roiling markets and creating undue volatility. Hedge fund managers, in contrast, view themselves as the ultimate exemplification of free markets – what better way is there, they ask, than to compensate money managers than on performance rather than on assets under management. As a sell-sider interested in self-preservation, I don't feel compelled to come down on either side. I do believe, however, that the growth in the hedge fund structure represents a seismic shift in the nature of money management and the industries that seek to service it.

According to the Hennessee Group, there are roughly 5000 hedge funds in the U.S. with assets of $500 billion. These figures represent an asymptotic rise from the $10 billion or so in these funds in 1991. There are few signs that this phenomenon has run its course. Anecdotally and through my observations at our small shop, it seems that talented money managers and analysts are breaking off from traditional firms and other hedge funds with greater and greater frequency. Regardless of one's feelings about hedge funds, there are a number of implications for the buy-side and sell-side alike.

Death of the Buy-and-Hold Strategy

Of all the industries ripe for consolidation in the U.S., the money management and brokerage industries are near the top. Increasingly traditional money management firms are being forced to compete with hedge funds for assets and for talent. This process is undoubtedly being hastened by the fact that institutional investors such as pension funds and endowments are becoming increasingly comfortable with alternative investment structures. As flows into equities dry up, the competition for the marginal dollar is intensifying. Chasing performance has become the norm, turning traditionally staid mutual funds into gunslingers. According to Bain & Co. the average holding period for stocks in the U.S. was eight years in 1960, versus eleven months today. Practically speaking, a buy-and-hold strategy is becoming impossible for any fund manager wishing to hold onto his job. As a friend of mine who runs a fund said, "I could get fired a lot of times in eight years." All of this focus on short-term performance is good for brokers, but may not ultimately be in the best interests of shareholders. In terms of turnover and commission generation, some mutual funds are increasingly being operated like their hedge fund competition.

The Concept of Paying For Performance Gains Traction

There are elements of the growth in alternative investment vehicles that seem eerily reminiscent of the Internet boom of the late 1990s. The growth is rapid, the barriers to entry are almost nonexistent, and there are large numbers of young people who are leaving good jobs with the hopes of instant riches. But, there is one element of the hedge fund structure that suggests that this phenomenon is in the second inning rather than the eighth: increasingly pension funds and endowments are carving out a portion of the funds earmarked for equities to alternative investments.

What is most attractive about hedge funds to these long-term investors is their desire for non-correlated returns and perhaps, more importantly, the idea that fees are dependent upon performance. How non-correlated these returns will be and whether a 1% management fee and a 20% performance fee is an appropriate fee structure for all hedge funds, regardless of size, historical performance, or reputation, remains to be seen. At least some investors have wondered whether such outsized fee structures encourage inordinate risk-taking.

We once asked a good friend of ours in the hedge fund business why no one ever tried to compete on price – i.e. why wouldn't a hedge fund accept less than the standard 1% management fee and 20% of the profits. His response: "No one would have any confidence in a manager who charged less." At once amusing and accurate, this comment underscores the idea that throughout their history, hedge fund investments have been seen as a luxury good ruled by inelastic pricing. While this may start to change, the increased interest in alternative investments from some of the country's largest investment pools may force traditional money management companies to reconsider their fee structures and come up with new and innovative ways to price their services.

Regulatory and Competitive Blowback

The growth of hedge funds has hardly gone unnoticed and it seems highly unlikely in the current environment that regulators and traditional money management firms aren't forming some sort of response. Financial shenanigans at brokerage firms and public companies have left regulators in a less-than-generous mood in their dealings with all financial institutions. Hedge funds are unlikely to be immune. The Treasury Department and the SEC have already started to indicate that greater oversight of hedge funds is in the works.

The responses from hedge funds' buy-side competition are more diffuse. While some mutual funds have already started their own hedge funds to retain talent, some responses being considered are more aggressive. In our travels around the country, we have started to hear rumblings among institutional investors about the wisdom of participating in stock-loan programs. "For 10 to 15 basis points, why on earth should I provide ammunition to the shorts that are killing our long positions every day?" asked one of our friends. I have sometimes felt afraid for my own safety when I have mentioned this last point to my friends at hedge funds. Whether such an action would actually stem the decline in stocks or merely dampen liquidity remains a mystery. But, anyone running a hedge fund should be aware that this response is at least being considered.

Research Becomes Short-Term

When I first started in this business as an institutional salesman eleven years ago, just about anyone on the sell-side - from the receptionist to the CEO - could have reeled off the names of the Street's top 5 customers. Fidelity. Alliance. American Express and so on. Today, it's pretty likely that neither the receptionist nor the CEO could come anywhere near naming their firm's best customers, because most didn't exist five years ago. We heard that one major hedge fund with $800 million in assets paid $50 million to the Street last year in commissions. $50 million! Though this may be some lurid fantasy of an over-eager sales manager, it's hard to deny that trading volume from hedge funds has become so large that some sell-side firms have sprung up just to cater to them. The result of this shift in the balance of commission power will be the increasingly short-term nature of sell-side research. Expect to see more of a focus on technical analysis and pairs trades. There is, of course, nothing wrong with this. But long-term investors should know where the sell-side's bread is buttered.

Ultimately, the growth in the hedge fund structure may fall under its own weight. Of the nearly 5,000 in total, there may be relatively few, in the final analysis, that can provide consistent above-market returns. In the meantime, short and long-term investors alike should be aware of the uncommon influence these new investment vehicles are currently having on the business as a whole.

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